STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois Commerce Commission On Its Own Motion	)	
vs.	)	Docket 01-0707
The Peoples Gas Light and Coke Company	)	
Reconciliation of revenues collected under gas adjustment charges with actual costs prudently incurred.	)	

THE CITY OF CHICAGO'S
PRETRIAL MEMORANDUM CONCERNING HEDGING ISSUES

Pursuant to Section 200.310 of the Rules of Practice of the Illinois Commerce Commission (Commission), the City of Chicago (City) submits its Pretrial Memorandum Concerning Hedging Issues. This Memorandum conforms to the outline set forth in the May 12, 2004 Order of the Administrative Law Judge (ALJ) .

In its direct testimony to date in this proceeding, the City has addressed a single issue – an assessment of the prudence of the gas procurement decisions, actions, and practices and policies of The Peoples Gas Light and Coke Company (Peoples Gas) in preparation for and during the 2000-2001 Purchased Gas Adjustment (PGA) charge reconciliation period.

With respect to hedging, the Commission's Order Commencing PGA Reconciliation Proceedings, the Commission expressly required Peoples Gas to address the prudence of its hedging activities to provide price risk management with respect to PGA charge gas costs.

> Each utility shall also demonstrate that its gas supplies purchased during the reconciliation period were prudently purchased. In addition, the company shall describe the measures, if any, taken by the utility during the reconciliation year to insulate the PGA from price volatility in the wholesale natural gas market explaining any hedging strategies utilized,

> the extent to which the strategies were actually implemented, and the actual impact on the PGA of implementing the strategies.

Through expert testimony of John Herbert, a former member of the FERC staff, the City will present pertinent facts from the months leading up to and during the reconciliation period. On the basis of that evidence, the City's expert concludes that Peoples Gas was imprudent in failing to put in place, and to use, a reasonable, effective plan to manage gas price risk on behalf of its captive utility customers. Peoples Gas' failure to implement prudent price risk management during the reconciliation period (October 2000 through September 2001) harmed Peoples Gas' customers in an amount Mr. Herbert has estimated at approximately $230 million.

In accordance with the directives of the ALJ's Order of May 12, 2004, this Memorandum summarizes (for hedging issues) the City's positions respecting:

- ❑ the uncontested and contested evidentiary elements of the City's case;
- ❑ the uncontested and contested legal issues raised by the City's case;
- ❑ planned City witnesses;
- ❑ relevant federal laws or regulations (with citations);
- ❑ appropriate disposition of the issues the City has raised, including specific relief; and
- ❑ identification of the relevant portions of Peoples Gas' corporate affiliates structure.

The City notes that it and other parties (other than Peoples Gas) have not yet submitted rebuttal testimony that could provide additional information respecting some of the matters addressed.

I. **Statement of Uncontested Facts**

The factual assertions noted below are classified as “uncontested” based on a review of the direct and rebuttal testimony filed to date by the parties. In particular, we have reviewed the direct testimony of the City’s expert, Mr. John Herbert, to identify those matters of fact that have not been contested by any other party to this proceeding.

In the following outline of uncontested facts, we have not attempted to identify or to classify testifying experts’ opinions and conclusions.

Background

1. During the reconciliation period (October 1, 2000 through September 30, 2001), Peoples Gas supplied gas distribution services and the gas commodity to City residents pursuant to tariffs filed with the Commission that permitted a pass-through of the utility’s prudently incurred gas supply costs.
2. Price risk in natural gas markets surfaced in the 1980's with the restructuring of the gas industry. By 1990, the price risks on supply contracts was sufficiently great, and contract terms were sufficiently standardized that a gas futures market developed at the New York Mercantile Exchange. Herbert Direct, L223.

Risk Management

3. Hedging for gas utilities is an appropriate risk management tool and should be pursued with the objective of reducing risks for customers. Graves Rebuttal, L212 *et seq*.
4. Hedging programs can reduce volatility, though not necessarily prices. Hedging “does alter the extremes that realized costs could possibly reach under a less-hedged procurement program.” Graves Rebuttal, L272.; Herbert Direct, L316, L413.

5. Hedging contracts provide protection against price volatility and fix the cost for a certain quantity of a commodity. Options operate like an insurance policy against extreme price levels defined by the option. Graves Rebuttal, L242; Herbert Direct L267, L391.

6. Volatility, a measure of price risk (represented as a percentage) quantifies the likelihood of price changes of a certain magnitude over a certain period of time. The greater the volatility, the greater the chance of large price movements. Herbert Direct, L462.

7. Additionally, for a given level of price volatility (*e.g.*, annualized volatility of 40%), the potential effects on customer bills are greater when the base price itself is high; 40% volatility in an environment of higher prices represents greater customer exposure to high bills than 40% volatility when prices are lower. Herbert Direct, L803.

8. Hedging alters the cost (price to customers) extremes that may be realized, and protects customers against economic effects of extreme gas prices. Graves Rebuttal, L272 *et seq*.

9. By matching physical and financial contracts for gas, a company can cap or fix the ultimate price of a portion of its expected purchases. Herbert Direct, L267.

10. Hedging contracts provide protection against price volatility and fix the cost for a certain quantity of a commodity. Options operate like an insurance policy against extreme price levels defined by the option. Graves Rebuttal, L242; Herbert L267, 391.

<u>Peoples Gas' Capabilities</u>

11. Peoples Gas was familiar with hedging concepts and practices, having proposed in 1998 a program to fix gas prices for its customers using NYMEX options. Peoples Gas' affiliates also were familiar with hedging, and actively used sophisticated financial

hedges to manage exposure to commodity price risk in operations where that risk could not be shifted to their customers. Herbert Direct, L600, *et seq*.

12. In the market in which Peoples Gas operated, effective hedging was feasible for Peoples Gas. Herbert Direct, L846, 912.

<u>Reconciliation Period Market Environment</u>

13. The market conditions in the period preceding Peoples Gas' summer 2000 injection season for the 2000-2001 winter were reflected in the following indicators:

    a. Annualized volatility for the 2000 injection season was near 50%, meaning that the standard deviation of expected price movement was 50% of the market price. Herbert Direct, L777.

    b. Volatility in April-October 2000 was some 13% higher than it had been during the corresponding period of the previous year. Herbert Direct, L785.

    c. Day-to-day price changes exceeded 10% for a significant number of days in the months preceding the 2000-2001 heating season. Herbert Direct, Ex. 1.2.

    d. The gas market price levels in some months of 2000 were about double those in comparable periods of 1999. Herbert Direct, L807.

    e. Supplies were inelastic, as indicated by the May 2000 jump in prices to about \$4.00/MMBtu. Herbert Direct, L751.

    f. The Commission's Natural Gas Committee held open proceedings in August 2000 to discuss the widely reported high gas prices and price volatility. Herbert Direct, L1103.

14. Gas prices were high and gas storage levels were low in the period leading into the 2000-2001 heating season (*i.e.*, the beginning of Peoples' reconciliation year). Herbert, L144.

Peoples Gas' Risk Management Actions

15. During the preparation period for the reconciliation period heating season, Peoples Gas relied on the same purchasing and storage practices it had used in prior years, despite changed circumstances. Peoples did not take measures to cap or to fix prices during the injection season, entering into fixed price contracts only after the heating season for the reconciliation period. Peoples did not financially hedge its gas purchases during the winter months. Herbert Direct, L158, L1054; Graves Rebuttal, L656

16. Peoples Gas' customers were exposed to gas price risk during the winter heating season of the reconciliation period. Graves Rebuttal, L655.

17. During the same time period, affiliates of Peoples Gas (including its parent company) were actively engaged in gas price hedging (including sophisticated financial hedge products) and aggressive hedging using less common risk management products to protect the companies and shareholders. Herbert Direct, L660 *et seq*.

18. Despite having recently proposed to use options hedges to manage its price risk and the contemporaneous hedging activities of its affiliates, Peoples Gas rejected the idea of buying options to manage gas price risk for its customers who paid gas costs through PGA charges. Herbert Direct, L664; Graves, L660 *et seq.*

Harm to Consumers

19. Gas prices during the reconciliation period – especially during the 2000-2001 winter – reached record highs. Some customers paid gas bills that were two or three times greater than their historical bills. Herbert Direct, L445.

20. The price levels that were reached and sustained during the winter of 2000-2001 were extreme, and the precise levels were unpredictable, but gas price spikes were not unprecedented, having occurred in 1995-1996 and 1996-1997. Graves Rebuttal, L2749 et seq., Ex. FCG-2; .Herbert Direct, Ex. 1.3.

21. The likelihood of price changes of significant magnitude was signaled by reported volatility measures. Herbert Direct, L144.

22. The total cost of gas to ratepayers was higher without hedging than it would have been with a prudent price risk management program. Herbert Direct, L1204; Graves Rebuttal, L849.

23. The hedging program Mr. Herbert used to calculate damages to consumers was a reasonable proxy for a plan that Peoples Gas could have implemented for the reconciliation period. Herbert, L1305; Graves, L915.

24. Using the risk management proxy defined in Mr. Herbert's testimony, the amount attributable to costs that were imprudently incurred by Peoples Gas and passed on to consumers is estimated at about $230 million (of the more than $600 million in increased revenues Peoples Gas collected in the reconciliation period). Herbert Direct, L175, L1387.

II. Statement of Contested Facts

The factual assertions noted below are classified as "contested" based on a review of the direct and rebuttal testimony filed to date by the parties. In particular, we have reviewed the direct testimony of the City's expert, Mr. John Herbert, to identify those matters of fact that have been contested by another party to this proceeding. In the following outline of contested facts, we have not attempted to identify or to classify testifying experts' opinions and conclusions.

1. The Sufficiency of Market Indicators in the Lead-up to the 2000-2001 Heating Season in Providing Information to Make Hedging on Behalf of Peoples Gas' Customers Prudent.
   a. Herbert: There were clear indications that gas commodity prices were both high and volatile in the period leading up to the reconciliation period (Peoples FY 2001), conditions that were readily discernible from standard industry data. Peoples failed to make the price risk management decisions indicated by contemporaneous market conditions that were known or should have been known to Peoples. Herbert Direct, L144. L155.
   b. Graves: The volatility increases, high prices and tight supplies heading into the 2000-2001 heating season did not provide self-evident signals that Peoples gas should have a hedging program. Graves Rebuttal, Lxxx, L135, L714.
2. Whether Peoples Gas Actually Had in Place and Followed a Prudent Price Risk Management Plan.
   a. Herbert: There is no clear evidence that Peoples Gas had a risk management plan in place that benefitted customers during the reconciliation period winter or that it

heeded the advice of risk management experts it had retained. Herbert Direct, L890 *et seq*.

b. Wear: The Company followed two separate price protection plans during the reconciliation period. Wear Direct, L134.

3. The Price Effect of Peoples Gas' Utilization of its Storage as a Price Hedge.

a. Herbert: Because of the manner in which Peoples Gas prices its withdrawals from storage, the cost of its stored gas is a complicated floating cost. Peoples Gas' storage had no hedge effect for consumers. Herbert Direct, L1150, 1176.

b. Wear: Mr. Herbert's assessment that Peoples Gas' use of its storage during the reconciliation period provided no price hedging benefit to ratepayers is affected by the fact that imprecise estimates of system requirements can be caused by (a) errors in weather forecasts and (b) no-notice balancing requirements. Peoples Gas' use of storage was an effective hedge in 2000-2001, and the savings produced by its use of storage was approximately $130,000,000. (Peoples Gas' calculation: the difference between wintertime market prices and the cost of replacing gas later (emphasis added).) Wear Rebuttal, L1266, L1294, *et seq*.

4. The Reasonableness of the Hedged Volumes Used in Mr. Herbert's Estimated Damages Calculation.

a. Wear: Mr. Herbert's estimate of the volumes Peoples Gas could have included in a hedge program is not realistic (operationally feasible), because of Peoples Gas' storage activity and the daily variability in Peoples Gas' purchases. Wear Rebuttal, L 1305, *et seq*.

b. Herbert: The volume used represents the amount of gas that will, with the greatest certainty, be purchased, a conservative amount. There is no evidence that Peoples Gas had a risk management plan in place during the reconciliation period or that it heeded the advice of risk management experts it had retained. Herbert Direct, L1217.

5. The Basis for Mr. Herbert's Hedging Recommendation

a. Graves: Mr. Herbert's recommendations for a prudent hedging program, active risk management in a volatile, high price market, and a disallowance for failing or refusing to hedge known price risks was based "on the incorrect grounds that hedging demonstrably would have reduced costs." Graves at 920.

b. Herbert: "I believe that every major utility should have a price risk management program." "Moreover, prudence in managing price risk does not depend on after-the-fact determinations of whether prices went up or down. Such comparisons are relevant only after a determination of imprudent (or no) action to manage price risk -- to calculate the resulting bill impacts. Herbert Direct, L884, L497.

III. Stipulations to Be Presented at Trial

The City anticipates that parties will file joint stipulations respecting the authenticity (and other foundation aspects) of documentary evidence that was acquired through discovery.

IV. Uncontested Legal Issues

1. Peoples Gas can lawfullly recover through PGA charges only reasonable and prudently incurred procurement costs.

IV. Contested Legal Issues

1. Does the regulatory concept of "prudence" require a gas utility to manage the price risk that it shifts to consumers through purchased gas adjustment charges as a reasonable business person would do under similar circumstances?
   a. Mr. Graves testimony suggests that Peoples will argue that, absent an express directive to do so from the Commission, it had no obligation to manage the price risk associated with the gas it provided to customers under tariff and for which it assessed PGA charges.
2. Is the Commission barred from enforcing its prudence requirements because an estimate of the economic harm to ratepayers is required?
   a. In particular, is the Commission precluded from awarding relief to consumers in this case for the damages from Peoples Gas' failure to hedge because, as Mr. Graves asserts, any proxy for the prudent risk management actions that Peoples Gas did not undertake , incorporates "arbitrary . . . assumptions of the hedges that would have been undertaken." Graves Rebuttal, L908.
3. Can Peoples Gas' customers lawfully be compelled to pay for the cost consequences of Peoples Gas' lack of prudent price risk management while Peoples Gas is held harmless at ratepayers' expense?

4. Are the contemporaneous hedging activities of Peoples Gas' affiliates during the reconciliation period evidence of how reasonable business persons would respond to the market conditions existing at that time?

V. The City's Suggested Disposition of Issues, and Relief Requested

The Commission should make the following findings of fact and conclusions of law on the basis of the evidence of record and the applicable statutes and regulations.

1. In providing services and products under tariff, utilities have a legal obligation to act prudently, and they may recover only the just and reasonable costs of providing service.
2. In particular, Peoples Gas had an obligation to act prudently in managing the price risk of the gas commodity supply it procures on behalf of its customers.
3. The hedging activities of Peoples Gas' affiliates operating contemporaneously in the same industry and in the same volatile, high price gas market are evidence of how a reasonable, prudent business would manage the price risk that passed to customers through PGA Charges.
4. The market indicators during the period leading up to the reconciliation period heating season showed increased volatility and price levels, lower storage levels, and tight supplies. Even assuming that Peoples Gas' traditional procurement strategy was reasonable in previous years, there were sufficient indications of significant changes in the market that simply declining to do anything differently was no longer prudent.

5. Peoples Gas did not have a prudent gas price risk management plan in place for the reconciliation period. The report from the utility's consultants did not have characteristics of a plan that make it operational. In any case, there is no evidence that Peoples Gas was committed to (or did) act in accordance with that report.

6. Peoples decided not to manage the increased gas price risk, despite:

   a. evidence of: increased gas prices and volatility in the period when gas was purchased for the 2000-2001 heating season;

   b. customers' increased exposure to extraordinarily high bills from the combination of higher volatility and higher prices;

   c. Peoples Gas' demonstrated understanding of and capability for hedging, and

   d. its awareness of that its ratepayers were exposed to the price risks of the market.

7. Customers were harmed by Peoples Gas failure or refusal to manage its gas price risk prudently.

8. The estimation of damages proposed by City witness Herbert is reasonable and should be adopted.

9. Peoples Gas' legal position on calculation of damages, which is essentially that there can be no calculation of damages because any proxy for the risk management Peoples Gas declined to perform would be arbitrary, is rejected.

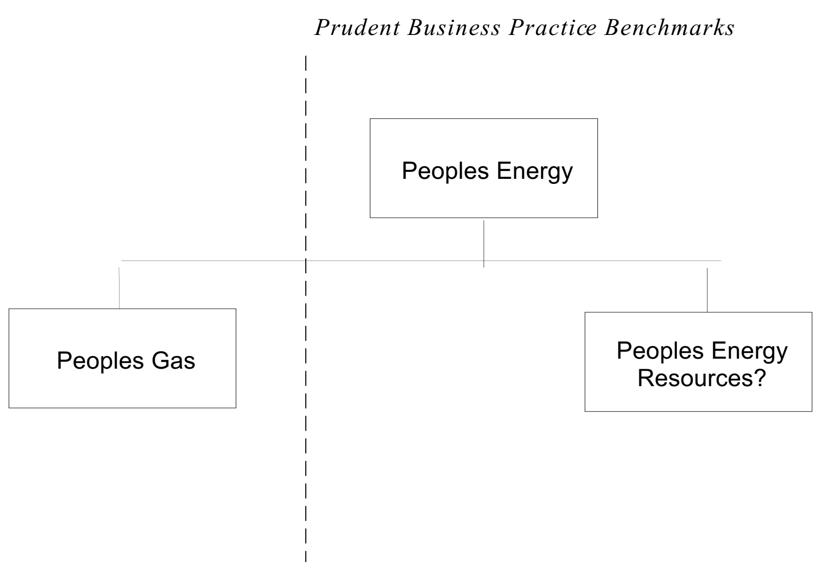
10. Peoples Gas is ordered to return to customers who paid PGA charges during the reconciliation period approximately $230 million in charges collected for imprudently incurred gas purchase costs.

VI. Acronyms and Terms (And Corresponding Definitions and Explanations) to Be Used at Trial

A Glossary of terms and acronyms is included in the Direct testimony of the City's expert witness, Mr. John Herbert.

VII. Chart of Pertinent Corporate Structure

Peoples Gas Corporate Structure
Pertinent to Hedging Issue



VIII. Citations to Pertinent Federal Laws or Regulations That Are Relevant to this Proceeding

None.

Dated: May 26, 2004

Respectfully submitted,

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